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ABSTRACT

There is growing number of proposals to develop a federal school construction program that shares the financial burden with local governments for renovating their obsolete school facilities or building new ones. This report examines recent public school construction projects; the efforts to make school construction a federal responsibility; alternatives to federal and state borrowing, including approaches from selected countries; and the advantages and benefits of private-public partnerships in school construction in the United States. Concluding comments examine the federal role in school construction and the legislative direction, as well as the risks inherent in establishing such a role. (Contains 28 references.) (GR)

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How Public-Private Partnerships Can Facilitate Public School Construction.

Ronald D. Utt

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The Heritage Foundation
Backgrounder 1

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How Public-Private Partnerships Can Facilitate Public School Construction

Ronald D. Utt, Ph.D.

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In recent years, the perception that there is a shortage of classroom space and that many existing school facilities are obsolete or badly deteriorated has led to a number of proposals in Congress to increase government spending and lending for the purpose of constructing school facilities. It also has led to a growing number of proposals to create some type of federal school construction program to share the financial burden that heretofore had been the sole responsibility of local governments, with growing assistance from state governments.

To date, none of these proposals has become law, and school construction remains the responsibility of states and localities. The increased intensity and frequency with which these proposals are put forward, however, ultimately may help these efforts to prevail. Such an outcome could weaken the American system of federalism, increase federal spending and lending, and centralize in Washington yet another responsibility of local government.

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One of the school construction bills introduced in the 105th Congress, however, offers an innovative approach to public school renovation and construction by harnessing the energy, resources, and expertise of the private sector. The Public Schools Partnership Act, introduced by Senator Bob Graham (D-FL) as S. 2397, would amend the federal tax code to allow the use of tax-exempt private activity bonds for the construction of privately owned

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school facilities leased back to the public school systems. If this bill were broadened to enhance its versatility, it could serve as the foundation for a legislative plan that encourages the use of public-private partnerships to build public schools more rapidly and at lower cost across the country.

PUBLIC SCHOOL CONSTRUCTION TODAY

In 1997, the United States spent a total of $35.5 billion on new school construction, of which $8.4 billion (or 24 percent) was spent on private schools--the fastest-growing component of total school construction spending. The $27.1 billion devoted to public school construction in 1997 represents an increase of 23 percent in such inflation-adjusted spending since 1993, while private school construction has soared ahead at 58 percent. Over the same period, the school-age population increased by 6.6 percent, suggesting that, at the most aggregate of levels, spending on school facilities outpaced the growth in student population.[1]

The recent aggregate national construction figures appear to be at variance with the prevailing view that there is a deficiency in the availability of quality school facilities. But such aggregate trends mask significant differences within and among communities and regions in the quality of school facilities. Such numbers, for example, tell little about the extent to which the condition of existing school facilities has deteriorated to the point at which it affects the quality of education or the safety of students, or the extent to which technological changes in instruction have rendered sound but older facilities below the desired standards and preferences. They tell little about the continuing demographic changes within and between metropolitan areas or regions that leave a surplus of facilities in one community--often depopulated central cities and rural communities--but severe shortages in others, such as the fast-growing fringe suburbs and exurbs.

Unfortunately, no systematic census or inventory of school facilities exists by which to make an accurate or objective assessment of their adequacy and needs. Neither is there a way to compare the information on what is available today to what existed in the past to determine whether the situation is improving (as aggregate spending data would suggest) or worsening (as anecdotes from select states and communities would indicate).[2]

Special Problems for Central Cities and the Fast-Growing Suburbs

In older cities and communities, the major school construction issue is the repair and renovation of older school buildings, many of which are in poor condition because of systematic neglect by city governments. In late 1998, for example, the chief executive officer of the District of Columbia schools announced a plan to spend up to $1 billion in school repairs over the next 10 years.[3] And in early 1999, New York City's Board of Education estimated it would need to spend $11 billion for school construction over the next 5 years.[4]

In response to concerns over the local stewardship of public school structures, some state courts have required the state government to provide financial assistance to cities to replace or upgrade school facilities; in other cases, the state government voluntarily chose to do so. In May 1998, the State of New Jersey, for example, was ordered by the New Jersey Supreme Court to replace or refurbish deteriorated school buildings in its 28 poorest school districts.

Governor Christine Whitman (R) responded by proposing to spend $5.3 billion over the next 10 years, of which $2.6 billion would be earmarked for those districts.[5] In Virginia, Governor James Gilmore (R) agreed to a new $100 million state-funded school construction program in order to get the state legislature to enact the personal property tax cut for automobiles he had promised during his election campaign.[6]

At the other extreme are the classroom shortages that often occur on the suburban fringe or in the exurbs, where population growth is at its most rapid and where school construction often fails to keep pace with student enrollment. As a result, classrooms and facilities may be overcrowded, and schools may set up temporary mobile classrooms to accommodate the growth in students. Often in these circumstances, school systems on the suburban fringe contend that the growth in tax revenues derived from the new households does not keep pace with the higher school construction costs incurred in serving them; they argue for state and/or federal financial assistance to meet their immediate needs.

A combination of such pressures in Michigan contributed to voter support for Proposal A in 1994, a ballot initiative put forth by Governor John Engler (R) to begin equalizing school funding in school districts throughout the state. Under the Engler proposal, voters were offered a higher state sales and income tax in exchange for lower local property taxes (with tax cuts exceeding tax increases). The state used the increased state tax revenues to provide each school district with a $4,800 annual payment per pupil. Among the benefits of the proposal was an end to the financial burden that a large influx of new students can create within school systems on the suburban fringe of metropolitan areas.

The effective result in each of these recent examples of change in state/local school funding is that state financial support has been substituted for the traditional local funding responsibility. Such a trend runs the risk that individual state governments may encroach further on other local education responsibilities.

EFFORTS TO MAKE SCHOOL CONSTRUCTION A FEDERAL RESPONSIBILITY

Although the trend toward greater centralization of school financial support to date has largely involved transfers of responsibility from local to state governments, considerable and growing pressure exists to move some of or all the responsibility further up the chain to the federal government. Washington heretofore has been a minor financial player in education whose assistance to local schools has been confined largely to a series of niche and add-on education programs.[7] That changed in late 1998, when Congress agreed to include in the fiscal year (FY) 1999 federal budget a $1 billion downpayment for a federal program to assist local school systems in hiring as many as a 100,000 new teachers over the next several years.

Such efforts to federalize public school financing are likely to continue in the 106th Congress as Members of both parties attempt to demonstrate their commitment to public education, which opinion polls suggest is an issue at the top of the list of voter concerns. But because education still is very much the responsibility of state and local governments, most of the resulting federal initiatives are likely to be directed toward devising new ways to send more money to elementary and secondary public schools.

A Flurry of Legislation

Indicative of the mounting pressure to tap the resources of the federal government for school construction, 31 bills were introduced on school construction finance during the 105th Congress alone. Many of these will be reintroduced this year, and their prospects for enactment are better than before. Among these bills, only one--S. 2397, Senator Graham's Public School Partnership Act--would encourage the creation of public-private partnerships between local public school systems and private, for-profit developers, a concept that is being implemented successfully in Canada, Great Britain, and even a few communities inside the United States.

Although S. 2397 did not reach the floor of the Senate for a vote, its language was incorporated in an amendment to the Education Savings PLUS Accounts Act (H.R. 2646) introduced by Senator Paul Coverdell (R-GA). H.R. 2646, as amended, passed the House and Senate with bipartisan support but was vetoed by President Bill Clinton for reasons having more to do with Senator Coverdell's A+ Accounts than with the public-private partnerships included in the amendment.

President Clinton's Proposal

In January 1998, President Clinton proposed a new federal tax credit to subsidize the interest costs on a total of $19.4 billion in special 15-year bonds issued by local school systems to construct or renovate their school facilities.[8] According to the Clinton Administration, the bonds would cost the U.S. Treasury an estimated $10 billion in interest rate subsidies over the next 10 years. Under the President's "Modern Schools for the 21st Century" proposal, the new federal school bonds would be issued over two years in face amounts of $9.7 billion per year. They would cover the construction costs of about one-third of the public schools expected to be built during those years.

Congress did not include the proposal in its FY 1999 budget. President Clinton attempted unsuccessfully to revive it in during the final days of federal budget negotiations in October 1998. He proposed this initiative again in his FY 2000 budget, but he increased the volume of eligible bonds to $22 billion.[9]

AN ALTERNATIVE TO FEDERAL AND STATE BORROWING

Although public financing of public schools has been the norm in the United States, all except one of the new legislative initiatives introduced at both the state and federal level last year would perpetuate and expand that practice by tapping into new governmental sources of money, notably at the federal level. In contrast to such proposals to extract more public resources to build public schools, a number of innovative approaches here and abroad clearly demonstrates that the private sector could build the desired facilities more quickly and for less money than currently is the case. The early success of these diverse efforts with public-private partnerships suggests that the key elements of these efforts could be emulated in most other U.S. public school systems, to the considerable benefit of students and the taxpayers who fund their education.

Nova Scotia's Partnership Approach

In 1997, Canada's province of Nova Scotia implemented one of the most ambitious programs to use public-private partnerships to facilitate the construction of new schools. By the end of 1998, as many as 41 new schools had been either completed or approved for construction under this Public Private Partnership program (or "P3," as it is known officially) and another 12 have been proposed for approval.[10] Drawing on the resources and talents of the private sector, P3 was implemented as a way to boost public services quickly while making as little impact as possible on Nova Scotia's limited budgetary resources.[11]

Nova Scotia has a population of approximately 947,000 (about as many as in the Oklahoma City, Oklahoma, metropolitan area) scattered across 55,362 square kilometers. With an unemployment rate hovering at just over 10 percent, an economy still suffering from the long-term decline of the North Atlantic fishing industry, and a freeze on the provincial capital budget since 1990, efforts to upgrade the school system might have been postponed pending the availability of financial resources. As it is, 38 percent of Nova Scotia's provincial budget is covered by transfer payments from Canada's federal government under a revenue-sharing program in which federal tax revenues from wealthier provinces, such as Ontario and British Columbia, are transferred to less-affluent provinces.

As a result of these pervasive financial shortfalls, Nova Scotia's government needed to tap alternative sources of money. According to the province's Ministry of Finance,

> The key objective is to enable Nova Scotia tax payers to get better value for their tax dollars by shifting the responsibility for the operation and/or financing of non-core activities to the private sector. In the process, the potential exists for service to improve within the same public expenditure framework, or for the same level of public service to be provided at a lesser cost to taxpayers.[12]

As the P3 program relates specifically to schools, the province's Ministry of Finance notes that:

> Schools delivered via a Public Private Partnership will be flexible, high tech learning environments to support programs and services for students during the useful life of the school. All technology will be integrated and provide valuable support tools for students and professional staff.
>
> These schools will be connected electronically to neighboring schools so that equitable access to technology is accomplished.
>
> The private sector will refresh the technology, and refreshed technology will be provided to other schools in the region.[13]

The first phase of Nova Scotia's P3 program encompassed as many as 41 new schools within three years. Eight already have been completed and now are in service, and agreements on the remaining 30 to 33 were approved and signed in early 1999. Twelve additional schools have been proposed but still await approval.

Under the P3 program, Nova Scotia's Ministry of Finance requests bids from qualified developers to provide one or several school facilities built to the ministry's specifications in a designated district. Completed projects are provided on a "turnkey" basis--the developer furnishes the desks, telephones, blackboards, and computers while the school system

provides teachers, principals, and students.

Prospective qualified bidders compete on price, and the cost of the project is converted into a 20-year lease with annual rent payments equal to 85 percent of the capitalized cost of the project. In effect, the school system gets to use the building for less than the cost to build and finance it, while the developer begins the lease 15 percent in the hole. In order for the developer to make up the difference in cost and earn a profit on his investment, the contract is structured so that the school system leases the building for specific hours, such as 8:30 a.m. to 3:30 p.m., Monday through Friday, September through June, as well as select off-hour periods. During the hours and days in which the public school system is not using the facility, the developer can rent its space to other approved and compatible organizations and businesses.

Off-Hours Use. Such off-hours use could include renting the facility to for- and not-for-profit educational organizations, such as trade schools and refresher educational programs, day care, community colleges and universities, civic groups, religious organizations, local governments, political groups, and similar entities for which classroom-, meeting-, and auditorium-type space is essential. Organizations and businesses whose purpose and activities are not compatible with a building used primarily by children are prohibited from leasing space, and such prohibitions are defined clearly in the contract. By using the building more intensively than would be the case if its occupancy were limited to just public school functions, the developer/owner of the building would obtain more revenues and earn more profit. These extra revenues are "passed on," in effect, to the public school system in the form of below-cost rent.

Because developers must compete actively with other providers of space for off-hours revenue, they have an important incentive to ensure that construction is done to high-quality standards and design. One of the first developers to win the right to construct and lease five schools, Nova Learning, Inc., also won the province's 1998 Lieutenant Governor's Design Award in Architecture.

Lease Terms. The school system's 20-year lease on each facility includes options to renew the lease at the same rent for up to two additional 5-year terms. The school system also has the option of buying the facility at a predetermined price if it so chooses. Most important, the school system has no obligation to rent the facility beyond the first lease term, thereby providing the developer/owner with a powerful incentive to maintain the building to its highest standard and upgrade it with the latest technology.

If the public school system determines that the original developer performed inadequately, it simply can contract with another developer for a new facility. Alternatively, if demographic changes in the province or community lead to a reduction in school-age children, the public school system can elect not to renew as many leases as necessary to match facility space with student population and consolidate its students in the leased facilities that remain. In any case, Nova Scotia's P3 program allows the school system to shift a number of important technological and demographic risks to the developer/owner and at the same time enhance its own flexibility and educational choices--at a lower cost than would be the case if the construction, financing, and ownership were entirely within the public domain.

As in any new program that differs significantly from the old, the first few schools built under the P3 program experienced some startup problems, which, in turn, were reviewed by

the province's Auditor General (AG) in a report to the government.[14] In particular, the AG did a comprehensive study of the first completed P3 school and raised a number of concerns about whether the long-term lease arrangement violated provincial budget rules and whether the purported cost savings were significant enough to justify the program. These and other concerns raised by the AG have been used to modify the program for the 30 schools most recently approved.

Scotland

The Scottish Office (which is the governing body responsible for policy initiatives under limited home rule) encourages the government and local communities to utilize private financial resources to fund the construction and renovation of public infrastructure, such as wastewater treatment facilities, hospitals, and "state" schools.[15] This program is entitled PFI (Private Finance Initiative) Scotland. As in Nova Scotia, PFI Scotland has moved beyond the pilot project stage and now is a fully operational component of the government's infrastructure program, particularly for public schools.

As of late November 1998, more than 70 schools with approximately 50,000 students in eight local authorities--including Scotland's two largest cities--were scheduled to be replaced or renovated under PFI Scotland. Included in the program were all of Glasgow's 29 secondary schools and Edinburgh's 27 secondary and primary schools.[16] The cost of this renovation and replacement initiative is expected to total £332 million ($554 million in U.S. dollars)--but it will be provided by private-sector investors.

To encourage these partnerships, the Scottish Office provides a subsidy to local authorities to meet the lease payments and operating costs. According to the Scottish Office,

> A schools project taken forward under PFI will generally involve a contract being signed between a local authority and a private sector consortium for the provision of educational facilities and infrastructure along with on going maintenance and non-educational operations. The length of the contract would normally be around 25 years. PFI projects do not require Councils to take loans. Instead they pay an annual charge for the services.[17]

Under this program, Glasgow's City Council has signed a contract with a construction company, which will receive a 30-year concession to improve and manage all of the city's secondary schools. When the offer first was announced in June 1998, formal expressions of interest came from around 40 businesses in the first week; these were narrowed down to a group of 6 qualified bidders who competed for the concession. The city expects that the concessionaire will upgrade all of the schools within 3 years, compared with an estimated 15 years under the former government-run system, and that the savings will amount to an estimated 30 percent below what it would have cost the city to upgrade and manage the school facilities itself.[18]

England and Wales

Beginning in 1997, the United Kingdom's Department for Education and Employment began to select a number of proposals for public-private partnerships for schools submitted by Local Education Authorities (LEA) in England and Wales for its financial support. This

program was implemented as a comprehensive nationwide pilot project to demonstrate the feasibility of alternative partnerships for school facility improvements. In order to encourage the development and submission of a diverse array of public-private proposals from the LEAs, the Department for Education and Employment offers approved projects a series of financial incentives to facilitate the implementation. The department believes that a program designed to test a variety of different techniques will be more accurate in determining what works best, and that the lessons learned from these experiments will help to guide the development of a more ambitious and comprehensive program in the future.

To date, the Department for Education and Employment has approved and funded three projects. These include a partnership to rebuild a secondary school in Dorset, another to build and operate a new primary school in Kingston-upon-Hull, and the third to build a new school music center, including a recording studio, in Waltham Forest. In the latter case, the private investor in the project expects to earn a return on his investment by leasing space in the music facility during afterschool hours. In addition to these 3 projects, another 23 proposals from the LEAs for 293 separate facilities have been approved for funding and now await final contract signing. An additional 18 proposals for more than 194 facilities have been submitted and are under review.

To encourage the submission of additional innovative school construction and renovation projects, the Department for Education and Employment provides the LEAs with the financial support to develop their proposals. As of September 1998, eight additional proposals were under development with such support.[19]

The Department for Education and Employment's approved projects reflect an eclectic mix of techniques and facilities. In addition to projects that involve the construction or renovation of school facilities, the approved projects include: (1) a long-term contract to replace the school kitchens in 66 Lewisham schools and provide all school meals, as well as meals for the community's social service programs (like Meals on Wheels) for a 10-year period; (2) a joint venture to provide energy repair and supply at more than 120 schools in Stoke-on-Trent; and (3) land swaps with the developers of new schools that allow them to redeploy the school's former sites for other purposes, such as housing.[20] In several of the land-swap projects, the estimated value of the land is used to defray some of the costs incurred in constructing the new building, thereby relieving the community's taxpayers of some of the financial burden.

HOW PARTNERSHIPS WOULD HELP SCHOOL CONSTRUCTION IN THE UNITED STATES

The success of private-public partnerships in other countries offers policymakers in the United States the framework for developing a cost-effective and timely means of financing and constructing public schools. In these countries, as in the United States, the decision-making and operating responsibility for public school systems lies primarily at the local level, albeit to varying degrees, with some financial support and regulatory guidelines imposed from above. In both Canada and the United States, schools are run locally but they operate under rules and standards established by the state or province and may receive significant financial support from the state or province for operating and capital costs.

Construction Cost Advantages

In the United States, publicly funded construction projects often are guided by an extensive series of costly regulations and mandates. Such mandates come in addition to the normal building safety and soundness requirements embodied in the local building codes, which all private and public construction projects follow in order to obtain building and occupancy permits. For example, with all federally funded projects, builders must adhere to provisions on payment of prevailing wages, environmental reviews, minority contracting, small business set-asides, origin of materials, and other constraints. All these provisions can add substantially to the cost of construction, compared with the cost to build an identical structure to local building code requirements and market-determined wages.

Although such mandates are at their most costly at the federal level, states have imposed similar mandates, which add to the cost of state- and locally financed projects, such as school facilities. Indeed, 31 states have their own Davis-Bacon-type laws mandating that prevailing wages be paid at all state-financed projects.[21] In states in which such restrictive laws exist, all public construction projects (including schools) are likely to cost more than they would if built under the competitive conditions that guide all privately financed construction projects. Depending on the way in which federal assistance is ultimately provided, these federal mandates might extend to a part of the U.S. economy that heretofore had been free of such burdens--at least for those 19 states without prevailing wage laws and possibly for another 12 states whose prevailing wage laws are less onerous than the federal law.

Even in the absence of state and federal regulatory mandates, privately funded and owned private-sector construction projects generally have a cost advantage over publicly funded projects because the owner has a powerful incentive not to waste money or incur unnecessary costs that will directly reduce or eliminate profits. With public construction operating with taxpayer money and in the absence of a profit incentive, the pressure to keep costs down is less compelling. Indeed, to the extent that such buildings become monuments to the existing political leadership, there often is the temptation toward costly and grandiose designs--frequently the case with federal office buildings, government housing projects, and courthouses.[22]

Case Studies in Florida

Pembroke Pines Public Charter School. Pembroke Pines, Florida, highlights just how significant such private-sector construction efficiencies can be. Pembroke Pines, a public charter school, teamed up with Haskell Educational Services (HES) of Miami, a subsidiary of the Haskell Companies--a firm that specializes in designing and constructing assisted-living facilities--to build and operate its new facility, which opened in September 1998. The cost of building the school was between 22 percent and 34 percent below that incurred for each public elementary school built in recent times. But while HES designed and built the school, the community financed it (with tax-exempt borrowing), owns it, and leases it to HES to operate as a charter school.

HES receives a state reimbursement of $3,750 per student per year, which is not sufficient to pay both school operating costs and the facility lease payments to the city government. Thus, HES has a powerful incentive to control costs and increase revenues. Any money saved through construction efficiencies, for example, means lower lease payments *and* fewer additional sources of revenue that must be found. As in the case with the

public-private partnerships in Nova Scotia, HES generates the additional revenues to cover the remaining costs and earn a profit by offering fee-based, after-hours programs at the school. At present, such programs are offered before and after normal school hours, on weekends, and during the summer, and include such services as day care, enrichment, and other education programs for students.

HES was able to achieve the necessary construction cost savings primarily by design efficiencies, including reconfiguring special-purpose rooms that otherwise would stand idle during the school day into multipurpose rooms that are used more intensively. The traditional teachers' planning rooms that typically occupy space between every two classrooms were reconfigured into small, computer-based media centers shared by the same two classrooms. The centers contain several computers that offer all the learning resources typically found in a school library, thereby obviating the need for a large school library. Because the charter school plans to have a more streamlined administrative structure than the typical public school (in 43 of the 50 states, public school systems have more administrative workers than teachers),[23] less administrative office space was needed.

Classrooms were built smaller than the average size in Florida that fits up to 35 students because of existing or prospective overcrowding. Pembroke Pines is committed, however, to limiting class size to no more than 25. Another important space and cost savings came from contracting out the daily food service, thereby eliminating the need for costly commercial kitchen facilities (and staff). Instead, the school has a much smaller "warming kitchen" in which prepared meals are brought in each day by the food service contractor and stored in the warming ovens until served. In a related savings, the cafeteria, which in many schools is used for only an hour or so a day, is designed to do double-duty by serving as a general-purpose meeting room and auditorium. In addition to the savings from these and other design efficiencies, better management of construction allowed for lower per-square-foot building costs as well.

As a result of these cost efficiencies, Pembroke Pines was built for $8,600 per "student station," compared with the Florida state experience of between $11,000 and $13,000 for public elementary schools. These design cost savings and efficiencies appear not to have deterred parent/student interest in the public charter school: Applicants to the school exceeded available space, and enrollment slots had to be allocated by way of a lottery. This occurred despite the fact that parents of Pembroke Pines students are required to provide 30 hours per year of volunteer service.

It is important to note that these savings are due mostly to the advantages of profit-driven, private-sector design and construction management efficiencies, compared with the public-sector building process. Florida does not burden its public-sector construction with the types of environmental, labor, and equal opportunity mandates that add to the cost of federally funded construction or public construction for states that impose such mandates. If Florida did impose these burdens, then the cost savings of a Pembroke Pines-type project, if privately financed, would be likely to grow even larger. This also suggests that the potential cost benefits of this approach could be quite substantial for the 19 states that have strong prevailing wage laws applied to public construction.

Public Schools at Private Work Sites. Florida also is home to another emerging concept in school public-private partnerships--large corporations that finance the construction of a public school at major work sites for the convenience of working parents. This offers

parents an attractive education option, minimizes their morning and evening transportation demands, and adds the convenience of afterschool day care services at the same facility. At least two such schools exist, one sponsored by NationsBank in Jacksonville and another built by the Orlando Regional Healthcare System. Executives at HES believe such schools offer the greatest near-term opportunity for public-private partnerships.[24]

OTHER ADVANTAGES OF PUBLIC-PRIVATE PARTNERSHIPS

In addition to the substantial cost savings public-private partnership offer compared with current publicly financed and managed school construction methods, there are other significant advantages.

Timeliness

Public-private partnerships can shorten the time between the determination that new school facilities are needed and the completion of the project. In most states and communities, acquiring funds for major public construction projects entails a complicated and lengthy process with an uncertain outcome. Once a need is recognized, hearings must be scheduled and held by the community's elected body, usually a city or county council. Depending on state law, the bond issue needed to raise the money then must be submitted to the voters for approval; this sometimes must wait until the next election, which may be a year or two away.

Because there is no assurance that the voters will approve the bond issue (in 1998, voters rejected 33 percent of school bond issues),[25] none of the necessary work that must be finished prior to construction--including engineering, design, and bid solicitation--can go forward until the bond offering is approved. As a result, as many as five years could pass before the school is ready for occupancy. By placing the financial responsibility with the developer/owner and eliminating the need for the public sector to raise the capital, the time-consuming political and legal approval process can be greatly shortened with private-sector partnerships, although the time saved will vary from state to state and community to community depending on existing procedures and laws.

With public-private partnerships, once the elected officials decide to go forward with the new school, they can go right to the bidding process with competing developer/owners, although instead of competing on the price to build, developers compete on the long-term lease rates they will offer.

Flexibility

Under the build/own process that characterizes most construction of public facilities today, there is little leeway in devising construction, financing, and operating arrangements that more closely fit the particular needs of a community. For rapidly growing communities with a steadily escalating school-age population, classroom space can be added only in periodic and costly lumps whose "cost-to-carry" initially will exceed tax revenues generated by new residents and businesses. As a consequence, such communities often have higher-than-average tax rates; many respond simply by prohibiting or severely limiting population growth by way of restrictive land-use regulations or high "impact fees" on each new house or apartment.[26]

The flexibility of public-private partnerships can overcome these cost constraints by designing and offering capital project packages a community can grow to fit. Such fast-growing communities have capital needs beyond just schools, including libraries, community colleges, and government office space, all of which may exceed a community's current borrowing capacity significantly. Such communities may also be short of other non-public facilities, such as day care, job training, driver education, and places of worship.

By using the Nova Scotia model, developers could build facilities that initially serve multiple purposes and are used intensively in off-hours for a variety of community purposes. As the population (and tax revenue) rises, a combined elementary/middle school and public library branch could be replaced with separate facilities for the two schools and another for the public library. Under this approach, fast-growing communities would face rising rental fees that more closely match rising tax revenues, instead of the periodic, large capital expenditures that may impose burdensome debt service requirements on a still-thin tax base.

For older, established suburbs with stable overall populations but widely fluctuating school-age populations due to demographic cycles, the partnerships of the Nova Scotia approach would give the community the flexibility to add or delete classroom space at minimal cost, which would allow 20-year leases with options to renew or terminate. If, at the end of 20 years--or whatever period is deemed appropriate--the school-age population declined, the school system could consolidate the remaining students in a smaller number of schools while the developer bore the risk of re-renting the space. In the event that the demographic cycle repeated itself, the school system could re-contract for new space as may be needed temporarily. In either event, the risk of holding costly empty space would fall on the developers/owners, whose expertise and entrepreneurial skills make them better-suited to recycle the space quickly and more profitably to its best use.

For central city schools, in which years of financial mismanagement have left an inventory of very old and poorly maintained facilities, declining student enrollment has led to vacant or underutilized buildings and ongoing consolidation of students and teachers in better facilities. Here, too, public-private partnerships could provide the key to promoting rebuilding and replacement programs, particularly because many central cities have precarious financial conditions that preclude or limit their access to bond markets. With a shrinking need for many of the facilities such school systems currently own, a central city public-private partnership could incorporate elements of the land-swap programs that Britain's Department for Education and Employment is trying as a way of tapping into the value of underutilized assets already owned by the system.

Such a program could involve either new schools or, considering the constraints on land suitable for development in many central cities, the substantial renovation of existing structures. For example, a private company could acquire a deteriorated building under a long-term lease, renovate it, and lease it back to the school system at a higher rent. Of course, more than just building repairs could be involved in the renovation: The contract also could call for the developer to provide a substantial upgrade in the building's telecommunications and information technology and to install computers and other learning devices in all the classrooms. To the extent that the developer could rent out portions of the facilities to other users on an after-hours basis, the rent paid by the school system for the improved facility would be less than the capitalized cost of the renovation, as is the case under Nova Scotia's plan for new construction.

Community-Wide Benefits

In addition to the obvious improvements to educational services that these new facilities would provide on a less costly basis, the availability of additional, conveniently located meeting and classroom space would foster other for- and not-for-profit activities that benefit the members of the community as well as school-aged children. Leasing space to one or several day care providers before and after school hours would benefit working parents and promote the safety of children who otherwise might be transported from one facility to another or become "latchkey" children at home.

Likewise, other non-school-sponsored, afterschool programs could utilize the space and reduce the time that children otherwise might spend going from place to place. Moreover, by putting many afterschool services within a single facility, the community would allow students greater access to activities they otherwise might not be able to attend for lack of transportation. Similarly, programs of interest to adults--whether civic groups, continuing education, work-related refresher courses, political meetings, or job training programs--could lease the space in the school building.

PRIVATE-SECTOR INTEREST

Although growing evidence from Canada, Great Britain, and a few U.S. communities suggests that public-private partnerships for school facilities can be attractive for public school systems, there is not much documentation to indicate that the concept offers private U.S. real estate investors and developers an attractive investment option. That might be changing, however, as evidence begins to emerge that, here and there, a few communities and a few entrepreneurs are experimenting with public-private partnerships for public schools.

For example, LTC Properties, Inc., in Oxnard, California, a real estate investment trust holding nearly $500 million in assets, notes the following change in its investment policy in its quarterly 10Q report to the U.S. Securities and Exchange Commission. (Up to this point, the firm had focused exclusively on investment in assisted-living facilities.)

> After a careful ongoing study of the child-care and education industry, during the six months ended June 30, 1998, the Company invested approximately $7,936,000 in two private schools and one charter school. These schools are leased to a publicly-traded company engaged in the operation of private and charter schools from pre-school through twelfth grade.[27]

This example and that of Florida's Haskell Education Services--as well as reports of exploratory interest by one of the country's major financial investors and by one of the "big six" consulting/accounting firms--may represent growing interest on the part of investors. It also shows that some have realized the opportunity. This suggests that there could be even greater growth in private investment in school facilities once school systems and investors become aware of the opportunity.

THE FEDERAL ROLE IN SCHOOL CONTSTRUCTION

The Influence of Tax-Exempt Borrowing

Although the federal government operates no explicit program to facilitate or fund the construction of public elementary and secondary schools,[28] it nevertheless has an important influence on school construction. It allows local communities to raise money for public construction by issuing bonds whose interest payments are exempt from federal income tax as well as any state income taxes for bondholders residing in the state of issue. Making such tax preferences available to investors in municipal bonds means that communities are able to borrow at lower costs than would be the case otherwise. In December 1998, when long-term AA taxable corporate bonds yielded 6.34 percent, the high-grade, long-term, tax-exempt municipal bonds yielded 4.17 percent, or more than two percentage points below the taxable equivalent.

Although the tax-exempt privilege imparts an important benefit to communities by enhancing their ability to afford new schools and other public infrastructure, that same privilege, under certain circumstances, can deter states from utilizing public-private partnerships. The cost advantages of the traditional, all-public approach often appears to be the least costly option, particularly if the alternative is a new and largely untried approach. But this need not be the case, as the growing, albeit limited, experience of some communities with various aspects of school partnerships suggests.

Potential savings from a well-conceived public-private partnership could overwhelm whatever cost benefits derive from using tax-exempt over taxable financing. Specifically, if (1) construction costs savings of 25 percent or more are possible (as in Pembroke Pines, Florida); (2) leases can be negotiated for rent levels equivalent to 85 percent of the (now lowered, as described in [1]) capitalized cost of the project; and (3) additional cost savings can be achieved by avoiding state (or federal) construction mandates and regulations, then the potential savings from unsubsidized public-private partnership borrowing at a higher *taxable* interest rate could more than offset the savings associated with the use of tax-exempt borrowing.

Such potential savings, dependent as they are on a new and novel way of building schools, may be seen as too risky and uncertain for many school districts to give up the certainty of using traditional forms of public construction. Considering the difference between the taxable and tax-exempt rates, as described above, a public-private partnership utilizing the taxable borrowing rate would have to generate a cost savings of at least 34 percent, compared with the traditional mechanism using tax-exempt financing.

For example, under the traditional approach with tax-exempt borrowing (4.17 percent), a school costing $10 million to build would require annual interest payments of $41,700 per year. But if built through a public-private partnership borrowing at the taxable rate (6.34 percent), then the same school would have to be built for only $6,600,000 to equalize such annual interest costs. The potential cost disparities between the two alternatives may make it difficult for many school systems to take advantage of the private-sector alternative. As a consequence, any effort to encourage local school systems to try a cost-saving alternative may have to be accompanied by interim subsidies comparable with those available by way of the existing tax-exempt borrowing privilege available to state and local governments.

LEGISLATIVE DIRECTION

Despite the increase in school facility partnerships here and abroad, there still is little awareness in the United States among public school officials, real estate investors, and policymakers of the benefits of public-private partnerships. These cooperative efforts offer the opportunity for the public sector to be more efficient in harnessing the resources and skills of the private sector to build more and better schools. Without this knowledge of private-sector opportunities, future legislative initiatives at the state and federal levels to boost school construction could result in more schools--although probably not as many as needed, and the additional public money spent would keep resources from other public needs. They also would run the risk of becoming another type of federal pork-barrel project, in which any congruence between spending and need occurred by chance.

Demonstration Projects

To explore innovative alternatives, the federal government and local officials should establish federal and state demonstration programs with financial incentives to encourage local public school officials to sign on. A federal financial incentive program to demonstrate the feasibility and benefits of public school construction through public-private partnerships could be structured so as not to add additional spending to the budget or increase tax revenue losses. The traditional approach to public school construction already entails significant federal subsidies by virtue of the tax-exempt status of the general obligation bonds that communities issue to fund their schools. To the extent that public schools would be built or renovated with the subsidies offered through a new public-private demonstration program, a portion represents schools that would have been built or renovated with funds borrowed with tax-exempt municipal bonds. This would not be likely to be a one-for-one offset in any given year, but the net "cost" per year could be only a small fraction of the total "cost" because of this substitution effect.

A Good Starting Point

A good platform to initiate a demonstration incentive program could be the Public School Construction Partnership Act, which was introduced as S. 2397 by Senator Bob Graham during the 105th Congress. This bill proposed amending the federal tax code to allow the use of tax-exempt *private activity* bonds for the construction of privately owned school facilities leased back to the public school systems.

Under current law, each state is provided an annual allocation, based on population, of tax-exempt private activity bonds to be used for such purposes as economic redevelopment, manufacturing, student loans, and home mortgages, but not public schools. A business as large as a *Fortune* 500 company can use these bonds to build or refurbish a for-profit manufacturing facility, but a company that wants to provide a building to the public school system is ineligible. Senator Graham's bill would rectify this exclusion and increase each state's bond allocation--by an additional $10 multiplied by the state population--so that the additional uses of the tax-exempt borrowing privilege would not come at the expense of other users, including major manufacturing corporations.

To address concerns about the potential for the increased loss of tax revenue, Senator Graham's bill could be modified to extend the use of tax-exempt private activity bonds to privately owned public school facilities but not to increase the state cap on the issuance of private activity bonds beyond those already scheduled to go into effect over the next few

years. This change would force corporations, hydroelectric projects, and other for-profit redevelopment projects to compete with schools for the available existing federal tax benefit. Alternately, Senator Graham's proposed increase in the caps and the ensuing loss in federal revenues could be maintained in the legislation but the revenue loss could be offset with the inclusion of legislative changes that would gain revenues.

One such possible legislative change is to add a somewhat modified version of the Higher Education Bond Parity Act, which was introduced as S. 1880 in the 105th Congress by Senator Daniel Patrick Moynihan (D-NY). S. 1880 would prohibit the use of tax-exempt general obligation bonds from being used to build costly stadiums and arenas for the owners of professional sports teams; the resulting revenue savings would be used to increase the number of private activity bonds that private universities and colleges could issue. By including privately owned schools that are leased to public school systems as investments also eligible for use with the savings achieved from the Moynihan bill, some of or all the potential revenue loss from this new program would be offset.

Improving Flexibility

Congress might want to consider also some modifications to the Graham bill to allow for more flexibility in structuring the nature of such arrangements between private developers and public school systems. As currently written, the bill would require that the arrangements be of the "build-own-transfer" (B.O.T.) type, which means that, at the end of the lease term (which would not exceed the term of the underlying bond issue), the facility would revert to the school system at no additional cost. Although this arrangement could be appropriate in some situations, it would preclude other arrangements that could be more advantageous to school systems in certain circumstances, and it also would limit the opportunity to experiment with other techniques to determine which works better under different circumstances.

For example, by allowing a lease arrangement that permitted (or required) the developer to retain ownership beyond the initial lease term (the Nova Scotia approach), the developer would have a powerful incentive to maintain and upgrade the building in order to encourage the school system to re-lease the facility. In addition, the school system would avoid the risk of having to retain a potentially obsolete or unneeded building that could be as old as 20 to 30 years by the lease's end. Permitting leases that let the developer retain ownership in perpetuity would allow the school system to negotiate lower annual lease payments than would be the case if the developer had to relinquish the building at the end of the lease term.

Another limiting component of the Graham bill that should be modified is its requirement that nearly all of a state's allocation to issue such bonds be used for school systems experiencing rapid growth in student population. This provision probably would cover most communities in the fast-growing states of the South and West, but in the slower-growing North and the Midwestern states, the bill's qualifications would limit the use of the bonds largely to distant suburbs. It also would prohibit the program's use (except for $5 million per state) in older central cities whose declining student populations often occupy old, deteriorated structures.

Pennsylvania, which has a student population of just over 12 million, the Graham bill would allow it to issue up $120 million of such public-private partnership bonds per year, but $5 million of that amount would have to be shared by Chester, Harrisburg, Philadelphia,

Pittsburgh, and perhaps six other declining cities in which substandard schools can be the norm. In such cities, in which renovation rather than new construction represents the most cost-effective response to school facility needs, public-private partnerships could help to restore aging structures, as they do in the PFI Scotland program in Glasgow, Scotland.

By allowing states more flexibility in allocating the special bond proceeds to systems in which the need is greatest, the public-private partnership approach would have the opportunity to demonstrate its efficacy and versatility under a variety of different conditions and needs. And out of these many and varied demonstration projects would arise a series of successful techniques, concepts, and approaches that could be implemented by states and localities across the country.

CONCLUSION

The many proposals to move the federal government into providing financial support for public school construction confront Congress with two considerable risks. The first is the prospect of creating a new budget-busting spending program that very easily could become another costly pork-barrel program. The lack of restraint Congress often demonstrates in regard to such infrastructure programs as highways and water projects would spill over very easily into a new school construction program as Members of Congress attempted to demonstrate their "commitment to education."

The second risk is that such a program could greatly expand the scope and power of the federal government into an area that traditionally has been the responsibility of local and state governments. Even if the program were oriented initially toward nothing more than providing cash for school construction, the temptation to add controlling strings to the cash would be difficult for politicians to resist--and every one of the added strings would undermine the local control of our public education system.

Of the many public school construction proposals that are likely to come before Congress, the approach embodied in Senator Bob Graham's Public Schools Partnership Act would allow Congress to avoid these risks, while at the same time allow local school systems to tap into the vast financial and management resources that America's private sector offers.

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1. U.S. Bureau of the Census, "Value of Construction Put in Place," *Current Construction Reports*, C30/98-11, November 1998, Tables 1 and 2, as found at *http://www.census.gov/prod/www/titles.htm#contsvy*.

2. One comprehensive effort to assess school renovation needs can be found in U.S. General Accounting Office, "School Facilities: Profiles of School Condition By State," GAO/HEHS-96-148, June 1996. Information compiled in the report was derived from a GAO questionnaire sent to a national sample of about 10,000 schools. Because of the varying technical expertise of the 9,956 respondents, state-to-state comparisons of quality and remediation costs may be difficult to make.

3. Valerie Strauss, "Ackerman Plans to Modernize D.C. Schools," *The Washington Post*, December 20, 1998, p. B1.

4. Jacques Steinberg, "Big Control, Little Accountability," *The New York Times*, January 25, 1999, p. A24.

5. David M. Halbfinger, "$5.3 Billion Proposed to Build or Repair Schools in New Jersey," *The New York Times*, October 5, 1998, p. A18.

6. Editorial, "Counter-Commission: State Should Exit the School Building Business," *Free Lance-Star* (Fredericksburg, VA), October 3, 1998, p. A12; Larry O'Dell, "School Buildings: F," *Free Lance-Star*, January 5, 1999, p. C1; and Dominic Perella, "Poll of Virginia Schools Finds Half Dilapidated," *The Washington Times*, December 18, 1998.

7. Explicit federal support has been forthcoming for the construction of facilities at colleges and universities since 1986, when Congress authorized the creation of the College Construction Loan Insurance Association (also called "Connie Lee"). Congress approved the privatization of Connie Lee in 1996, and the sale of government stock in the enterprise was completed in February 1997.

8. Office of Management and Budget, *Budget of the United States Government, Fiscal Year 1999* (Washington, DC: U.S. Government Printing Office, February 1998), p. 52.

9. Office of Management and Budget, *Budget of the United States Government, Fiscal Year 2000* (Washington, DC: U.S. Government Printing Office, February 1999), p. 66.

10. See, for example "Nova Scotia Schools Boom," *PWFinancing*, December 1997, p. 23, and "Nova Scotia Picks School Developers," *PWFinancing*, September 1998, p. 33.

11. Summary details of Nova Scotia's P3 program can be found in "Transferring Risk in Public Private Partnerships," the Ministry of Finance of the Government of Nova Scotia, at *http://www.gov.ns.ca/fina/minister/p3guide/p3g.htm#introduction*.

12. *Ibid.*, Section 1.4.1.

13. *Ibid.*, Section 1.4.2.

14. "Department of Education and Culture: O'Connell Drive Elementary School Lease," Special Report of the Auditor General, Halifax, Nova Scotia, July 21, 1998.

15. In Scotland and elsewhere in the United Kingdom, the term "state school" is used the same as "public school" in the United States; conversely, a "public" school refers in the United Kingdom to what people in the United States call a "private" school.

16. The Scottish Office, Edinburgh, Scotland, "Major Boost for Schools Buildings from Private Public Partnerships," News Release: 2408/98, November 20, 1998.

17. *Ibid.*

18. "Scotland Sets Largest Schools Deal," *PWFinancing*, July/August 1998, p. 13.

19. Department for Education and Employment, Government of the United Kingdom, "Public Private Partnership (PPP) Projects in Schools: Project List," September 1998.

20. A similar project in Philadelphia, Pennsylvania, is for an underutilized school facility on a large plot of land.

21. See Robert W. Poole, "Defederalizing Transportation Funding," Reason Foundation *Policy Study* No. 216, October 1996, pp. 5-7.

22. See, for example, U.S. General Accounting Office, "Courthouse Construction: Better Courtroom Use Data Could Enhance Facility Planning and Decision-Making," GGD-97-39, May 19, 1997; and National Park Service, "Special Report: Cost of Construction of Employee Housing at Grand Canyon and Yosemite National Parks," Report No. 97-I-224, December 1996, pp. 47, 65.

23. Peter Brimelow, "Top Heavy," *Forbes*, November 2, 1998, pp. 60-61.

24. "Fall Service Charter School Opens," *PWFinancing*, July/August 1998, p. 13.

25. From "Nationwide School Bond Referenda: 1978-98," table provided by American Banker Bond Buyer, One State Street Plaza, New York, NY 10004.

26. See Samuel R. Staley, "'Urban Sprawl' and the Michigan Landscape: A Market-Oriented Approach," Mackinac Center for Public Policy and Reason Public Policy Institute, October 1998, pp. 24-30, for an analysis of the cost burdens confronting fast-growing communities.

27. LTC Properties, Inc., "Form 10Q, for the quarterly period ended June 30, 1998," p. 7.

28. It has created, however, a government-sponsored enterprise (Connie Mac) to facilitate the financing of construction at colleges and universities.

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